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Volume 12 | Number 24

Article 2

12-7-2001

Cases, Regulations, and Statutes

Robert P. Achenbach Jr
Iowa State University

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Recommended Citation

Achenbach, Robert P. Jr (2001) "Cases, Regulations, and Statutes," *Agricultural Law Digest*: Vol. 12 : No. 24 , Article 2.
Available at: <http://lib.dr.iastate.edu/aglawdigest/vol12/iss24/2>

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CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

COUNTY ROAD. The defendant and plaintiff owned ranches which were separated by a strip of land. Each party had its own fence running along the disputed strip and the strip itself was used as a dirt road for access by other neighbors and hunters to land at the end of the strip. The defendant decided to develop a portion of the land as a residential subdivision and petitioned the county to place a paved road on the strip. The defendant discovered that a petition to designate the strip as a road had been granted in 1921; however, the petition was not properly recorded and no one else had any actual knowledge of the road designation, either among the previous owners, neighbors or the parties. The court held that the lack of notice prevented enforcing the road designation against the plaintiffs who held title to the strip. The defendants also argued that the use of the road by neighbors and hunters established the strip as a public road by adverse possession. The court found that most of the public use of the strip was by permission; therefore, no public road was established by such use. **Littlefield v. Bamberger, 32 P.3d 615 (Colo. Ct. App. 2001).**

BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS

HOMESTEAD. The debtors, husband and wife, owned two neighboring parcels of rural real estate which were claimed as a rural homestead exemption under Tex. Prop. Code § 41.002. One parcel was 59 acres and contained the debtors' residence and the other 26 acres were used as a mobile home park. The court adopted a blended test which first examined the property under the factors in the statute to determine whether the property was rural or urban. If the property met the statutory definition of rural, the property qualified for the rural homestead exemption. If the property was classified as urban under the statutory test, the nature of the property was examined under the traditional judicial factors. The court held that both parcels met the statutory rural test because the parcels were not within a municipal boundary and were not served by municipal utility services. However, the court held that the 26 acres did not qualify as residential because the property was used as a business. Therefore, the court allowed the exemption for the 59 acre parcel but not for the 26 acre parcel. **In re Perry, 267 B.R. 759 (Bankr. W.D. Tex. 2001).**

CHAPTER 12-ALM § 13.03[8].*

ELIGIBILITY. The debtor was a corporation wholly-owned by one person. The debtor's business was the raising, boarding and training of horses on rural property zoned for farming use. The court noted that the horse operation was subject to the same risks inherent in any farm operation and held that the debtor qualified for Chapter 12. **In re Showtime Farms, Inc., 267 B.R. 541 (Bankr. E.D. Tex. 2000).**

PLAN. The debtor's Chapter 12 plan modified a secured loan from a creditor by reducing the interest rate from 10 percent to 9.25 percent and changing the loan term from nine years to a 30-year amortization rate with a ten-year balloon payment. The creditor objected to the modification of the loan as not providing the creditor with the full value of the loan over the plan period. The court held that the modification of the loan term would not of itself prevent confirmation of the plan. However, the court held that the debtor failed to demonstrate that the 9.25 percent interest rate was the market rate of interest for this type of loan; therefore, the modification of the loan interest rate prevented confirmation of the plan. The court used a two-part test to determine the sufficiency of the interest rate: (1) there is a rebuttable presumption that the loan contract rate was appropriate and (2) the debtor had the burden to prove that the plan payment interest rate was the market rate for similar loans. **In re Showtime Farms, Inc., 267 B.R. 541 (Bankr. E.D. Tex. 2000).**

FEDERAL TAX-ALM § 13.03[7].*

DISCHARGE. The debtor had filed income tax returns for 1993 and 1994 but had altered lines 23 and 24 and replaced them with "Non-taxable Compensation" and had altered the jurat language at the end of the form. The debtor filed for Chapter 7 more than three years later and sought to have the taxes declared dischargeable under Section 523. The court held that the altered forms were insufficient to qualify as filed returns under Section 523 because the alterations did not represent an honest and reasonable attempt to satisfy the filing requirements. **In re Brumbaugh, 267 B.R. 800 (Bankr. S.D. Ohio 2001).**

SETOFF. The IRS had filed an unsecured priority claim and an unsecured non-priority claim for past taxes owed by the Chapter 13 debtor. The debtor filed a tax return for 1999 which claimed a refund. The IRS set off the refund against the non-priority tax claim and the debtor claimed that the refund should have been set off against the priority tax claim first. The debtor argued that allowing the IRS to choose which claim would be set off by the refund was unfair to other unsecured non-priority creditors. The court held that the setoff was proper and allowable under Section 553. **In re Crawford, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,769 (Bankr. W.D. Wis. 2001).**

FEDERAL AGRICULTURAL PROGRAMS

PACA. The Chapter 13 debtor and spouse owned a corporation which was a dealer under the Perishable Agricultural Commodities Act (PACA) which purchased produce from a producer but failed to make payment for the produce. The debtor had personally guaranteed the corporation's payment for the produce. The producer filed a claim in the bankruptcy case and sought priority for the claim under the PACA trust provisions. The producer argued that the debtor should be held liable under the PACA trust provisions because the debtor controlled the corporation and personally guaranteed payment. The court noted that there was no claim made that the debtor had received any of the proceeds of the sale of the produce. The court held that the debtor could not be held liable under the PACA trust provisions because the debtor was only secondarily liable for payment for the produce and had not received any of the proceeds from the sale of the produce. *In re Ozcelik*, 267 B.R. 485 (Bankr. D. Mass. 2001).

FEDERAL ESTATE AND GIFT TAX

CLAIMS. On the date of the decedent's death, the decedent was involved in a suit filed by the lessor of an oil lease for excess royalty payments made to the decedent. The lessor received some favorable rulings soon after the decedent's death but settled for a smaller sum than was originally sought from the decedent 15 months after the decedent's death. The decedent's estate valued the law suit claim as of the decedent's death, based on the money judgment sought by the lessor. The IRS argued that the claim was to be valued at the amount that the estate eventually paid or that the estate had discharge of indebtedness income when the settlement was reached to the extent the actual amount paid was less than the claim allowed for estate tax purposes. The court held that the value of the claim was to be determined as of the date of death, based on the information available at that time. The court also held that the estate did not recognize discharge of indebtedness income when it settled for an amount less than the claim's value as of the date of death. On remand, the Tax Court noted that the appellate court had rejected valuing the law suit at the time of death at the full amount sought by the lessor. The Tax Court also noted that the estate failed to provide any evidence of the value of the lawsuit as of the date of death. The Tax Court held that the IRS valuation was correct, based on all the evidence presented. *Estate of Smith v. Comm'r*, T.C. Memo. 2001-303, *on rem. from*, 198 F.3d 515 (5th Cir. 1999) *rev'g*, 108 T.C. 412 (1997).

FAMILY-OWNED BUSINESS DEDUCTION. In a Chief Counsel Advice letter, the IRS discussed several issues involving the I.R.C. § 2057(i)(3)(P) lien created by the FOBD election. The IRS stated that the lien should identify the real property involved in the election and not rely on identifying personal property such as stock in corporation which owns the property. The IRS also stated that Form 668H, Notice of Federal Estate Tax Lien, should be altered to include notification of the I.R.C. § 2057(i)(3)(P) lien. The IRS suggested that escrow agreements could be used to include personal property, such as corporation stock in the lien. Finally, the IRS stated that third parties with interests in FOBD property must also consent to the FOBD recapture provisions. See also Harl, "Liens for the Family-Owned Business Deduction," 12 *Agric. L. Dig.* 121 (2001). **CCA Ltr. Rul. 200148052, Oct. 16, 2001.**

MARITAL DEDUCTION. The decedent's entire estate passed to a marital trust for the surviving spouse, resulting in no estate tax. After the estate tax return was filed, the IRS assessed additional taxes and interest for a pre-death gift made by the decedent to the surviving spouse. That assessment was affirmed by the courts, but the estate sought to offset the tax and interest by estate administrative expenses which were in excess of the expenses claimed on the estate tax return. Some of the administrative expenses were charged to estate income and some to estate principal. The IRS argued that the administrative expenses would have to decrease the marital deduction because the expenses decreased the income and principal received by the surviving spouse. The court held that the extra administrative expenses charged to estate income did not diminish the marital deduction because the expenses did not constitute a material limitation on the surviving spouse's bequest. The court also held that the extra administrative expenses charged to estate principal reduced the marital deduction, although this did not affect the overall estate tax because the entire estate passed to the surviving spouse. The court held that the expense for the interest on the tax deficiency did not reduce the marital deduction. **Brown v. United States, 2001-2 U.S. Tax Cas. (CCH) 60,424 (C.D. Calif. 2001).**

TRUSTS. The decedents, husband and wife, had established an irrevocable trust funded with a life insurance policy on both decedents. The trust provided that the decedents' child was to be trustee and that upon the death of the second to die, the proceeds of the policy were to be paid to the trust. The trustee had the discretion to pay any inheritance, estate or income tax resulting from the taxpayers' deaths. The wife was the second to die and the insurance proceeds were not used by the trustee to pay any taxes resulting from the decedent's death. The IRS ruled that the insurance proceeds were not included in the wife's estate because the trustee was not obligated to pay the taxes. **Ltr. Rul. 200147039, Aug. 21, 2001.**

FEDERAL INCOME TAXATION

BAD DEBTS. The taxpayer owned an interest in several companies. One construction company loaned money to a real estate partnership. The promissory note stated an interest rate but no due date. The note was listed in several audits and reports to the FmHA (now FSA). The construction company terminated without paying the loan and the partnership claimed a bad debt deduction. The taxpayer argued that the promissory note, audits and FmHA reports proved the bona fide debt. The court held that the taxpayer failed to prove that the loan was a bona fide debt. The court discounted the value of the audits and reports because the information was supplied by the taxpayer. **Fedewa v. Comm'r, T.C. Summary Op. 2001-176.**

BUSINESS EXPENSES. The taxpayer was self-employed as a computer engineer and claimed three payments as business expenses. However, the taxpayer provided no corroborating evidence of the business purpose of the expenses and the court denied the deduction as business expenses. The appellate court affirmed in a decision designated as not for publication. **Simpson v. Comm'r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,750 (6th Cir. 2001), aff'g, T.C. Memo. 1999-274.**

CHARITIES. Several charities have made payments to individuals by reason of the death, injury or wounding of an individual incurred as a result of the September 11, 2001 terrorist attacks. The IRS has announced that it will treat such payments made by a charity to individuals and their families as related to the charity's exempt purpose provided that the payments are made in good faith using objective standards. The IRS noted that legislation in this area is pending in Congress. **Notice 2001-78, I.R.B. 2001-50.**

DEPRECIATION. The taxpayers owned an S corporation with a third party. The third party retired and sold the stock back to the corporation. The stock sales agreement did not allocate any portion of the sales price to a covenant not to compete by the third party and no covenant not to compete was included in the sales agreement. However, the taxpayers claimed amortization deductions for the alleged value of a covenant not to compete. The Tax Court held that no portion of the stock sales price could be allocated to a covenant not to compete because the parties to the sale did not allocate, or intend to allocate, any portion of the sales price to such a covenant. The appellate court affirmed in a decision designated as not for publication. **Miner v. Comm'r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,752 (9th Cir. 2001).**

PENSION PLANS. For plans beginning in November 2001, the weighted average is 5.74 percent with the permissible range of 5.17 to 6.03 percent (90 to 106 percent permissible range) and 5.17 to 6.32 percent (90 to 110 percent permissible range) for purposes of determining the

full funding limitation under I.R.C. § 412(c)(7). **Notice 2001-71, I.R.B. 2001-__.**

The IRS has issued tables of covered compensation under I.R.C. § 401(l)(5)(E) for the 2002 plan year. **Rev. Rul. 2001-55, I.R.B. 2001-47, 497.**

The taxpayer was a retired teacher. During employment as a teacher, the taxpayer made after-tax contributions to a pension plan. These contributions formed a tax basis in the pension plan which was allocated ratably to each year distributions were made after the taxpayer's retirement. The taxpayer argued that the basis from these contributions should be increased to reflect the amount of inflation which occurred after the contributions were made. The court held that the taxpayer's basis in the pension plan could not be increased for inflation because there was no authority in the statute or regulations for increasing basis because of inflation. The appellate court affirmed in a decision designated as not for publication. **Nordtvedt v. Comm'r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,772 (9th Cir. 2001), aff'g, 116 T.C. 165 (2001).**

PERSONAL HOLDING COMPANY. The taxpayer was a calendar year basis personal holding company. In September 1997, the taxpayer declared a consent dividend to its shareholders under I.R.C. § 565. All the shareholders signed the proper consent Form 972. The taxpayer filed these consents and Form 973 (Corporate Claim for Deduction for Consent Dividends) with its Form 1120 in September 1997, pursuant to an extension to file. Some of the taxpayer's shareholders were foreign persons. The taxpayer included a payment of 30 percent of the amount of the consent dividends attributable to the foreign shareholders with its Form 1120. Because the taxpayer had already filed its 1996 Form 1042, it filed an amended return to report the consent dividends in September 1997. The IRS assessed the taxpayer interest on the tax attributable to the consent dividends from the due date of the Form 1120, March 15, 1997, to the date the tax was paid in September 1997. The IRS ruled that the interest was assessed properly because, although the taxpayer had until the extended filing date to file the consent forms, the tax had to be paid by the original due date for Form 1120. **Ltr. Rul. 200147005, June 15, 2001.**

SAFE HARBOR INTEREST RATES

| December 2001 | | | | |
|-------------------|--------|-------------|-----------|---------|
| | Annual | Semi-annual | Quarterly | Monthly |
| Short-term | | | | |
| AFR | 2.48 | 2.46 | 2.45 | 2.45 |
| 110 percent AFR | 2.73 | 2.71 | 2.70 | 2.69 |
| 120 percent AFR | 2.97 | 2.95 | 2.94 | 2.93 |
| Mid-term | | | | |
| AFR | 3.97 | 3.93 | 3.91 | 3.90 |
| 110 percent AFR | 4.37 | 4.32 | 4.30 | 4.28 |
| 120 percent AFR | 4.78 | 4.72 | 4.69 | 4.67 |
| Long-term | | | | |
| AFR | 5.05 | 4.99 | 4.96 | 4.94 |
| 110 percent AFR | 5.57 | 5.49 | 5.45 | 5.43 |
| 120 percent AFR | 6.08 | 5.99 | 5.95 | 5.92 |

Rev. Rul. 2001-58, I.R.B. 2001-50.

PRODUCTS LIABILITY

FRONT LOADER. The plaintiff had owned a tractor and front-end loader for over 19 years. The plaintiff had altered the front-end loader by soldering on two brackets to hold a bale fork. The plaintiff was injured while transporting a large round hay bale when the loader lifted too high and caused the hay bale to roll back onto the plaintiff in the tractor. The tractor did not have a roll over protection system. The accident was apparently caused by a defective valve on the front-end loader which allowed the loader to rise without control. The plaintiff filed suit against the tractor and front-end loader manufacturer under the Kansas Product Liability Act, Kan. Stat. §§ 60-3301 *et seq.*, for negligence, strict liability and breach of warranty and included a claim for failure to warn. The defendant argued that its liability was extinguished by Kan. Stat. § 60-3302(a) because the tractor and front-end loader were past their useful safe lives. The statute provided a presumption that equipment over 10-years old was past its useful safe life. The plaintiff presented evidence of the equipment's condition and expert testimony that the tractor and front-end loader were not past their useful safe lives. The court held that the plaintiff had presented sufficient evidence of the tractor and front-end loader's condition to make their useful safe life a jury question. On the failure to warn claim, the defendant argued that the plaintiff had sufficient personal knowledge of the dangers involved in carrying large round hay bales to relieve the defendant of any duty to warn. The defendant also argued that the modifications to the front-end loader were sufficient to relieve the defendant of any strict liability. The court noted that, without the modification by the plaintiff, the front-end loader would not have been able to transport large round hay bales and the accident would not have happened. Therefore, the court dismissed the plaintiff's claim in strict liability because of substantial modification of the front-end loader. **Hiner v. Deere & Co., 161 F. Supp.2d 1279 (D. Kan. 2001).**

PROPERTY

CONVERSION. The plaintiffs were co-owners of timberland with the defendant. The defendant had purchased a two-thirds interest in the timber held by

siblings of the plaintiffs and had cut the timber or contracted with others to cut the timber without first obtaining permission from the plaintiffs. The defendant paid the plaintiffs their share of the value of the timber; however, the plaintiffs sued for conversion. The jury agreed with the plaintiffs' valuation of the timber and awarded the plaintiffs the difference between what the defendant paid them and one-third of the true value of the timber, plus the cost of restoration. The defendant argued that, as co-owner, the defendant had the right to harvest the timber. The court upheld the jury verdict. **Dillard v. Wade, 45 S.W.3d 848 (Ark. Ct. App. 2001).**

SECURED TRANSACTIONS

PRIORITY. The debtor had granted a security interest in farm equipment and after-acquired property to a bank in 1985. In 1998, the debtor borrowed money from a creditor to purchase more farm equipment and granted a purchase-money security interest (PMSI) in that equipment to the creditor. The PMSI also contained a future advances clause to cover any additional loans. In 1999, the debtor borrowed additional funds from the creditor and a new promissory note was executed which referred back to the original loan and security interest. The additional funds were used to purchase more farm equipment. The loan amount was increased again in 2000 under the same terms. The PMSI creditor argued that its security interest had priority over the bank's security interest because of operation of Iowa Code 554.9107(b) which provided superpriority to PMSIs. The court held that the "dual status" doctrine applied to the PMSI to allow superpriority status to the security interest to the extent the loan proceeds were attributable to the purchased equipment. To the extent the loan proceeds were used for other purposes, no superpriority was allowed. The court also held that the payments made by the debtor on the loan would be applied first to the first equipment purchases and then to the non-equipment purchase use of the loan proceeds, essentially a first-in first-out method. The court declined to make a final determination because the debtor and creditor had not provided sufficient evidence of the loan's history to determine the extent of funds attributable to the purchase of the farm equipment. **In re McAllister, 267 B.R. 614 (Bankr. N.D. Iowa 2001).**

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